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Effectiveness of Supervisory Boards: 5 Crucial Factors

Paper

In recent years the field of corporate governance has been characterized by an increasing effort to gain a better understanding of the impact of board characteristics on the financial performance of a firm (Dalton, et al., 1998; Sueyoshi, et al., 2010; Velte, 2010). Whilst some studies reported inconclusive findings (Larcker, et al., 2007), the majority of studies found empirical evidence supporting the idea that variables in the field of corporate governance influence a firm's profitability (Ezzamel, et al., 1993; Dehaene, et al., 2001; Iyengar, et al., 2009; O'Connell, et al., 2010). By implication, the notion that board design and attributes variously impact on a firm's financial performance is agreed upon.

However, while informative and managerially relevant, this literature remains dominated by an emphasis on a specific system of corporate governance, i.e. the one-tier system. Yet, only very little is known about the relationship between corporate governance factors and performance in the two-tier system. Yet, extant research indicates that the differences in terms of board structure and governance mechanisms, may affect the attributes and characteristics of effective corporate governance modes, which may differ extensively between the two. The most predominant difference consists in the clear separation of control and management in the dualistic system (Jungmann, 2006). This suggests that more research is needed in order to shed light on the extent to which our current knowledge also applies to boards in the dualistic system.

Accordingly, this study's objective is to analyze exclusively two-tier system settings and the relationship between boards and firm performance by investigating board designs and configurations. After reviewing the literature in this field, we investigate the fundamental characteristics of supervisory boards in a dualistic system, with focus on how to increase their effectiveness.

Our study projects several contributions to literature. First, we offer to enrich the current debate about the effectiveness of supervisory boards by measuring the interaction of board work and firm performance, which constitutes a key question in the discussion about how corporate governance influences a firm's performance viewed from the micro-perspective of the supervisory board. Second, we continue to build upon the small but growing literature on boards in the two-tier system, which is trying to illustrate both, the differences and similarities to the one-tier system, especially on the level of composition, work flow routines, decision making, as well as social and institutional ties. Third, our study illustrates why setting the research in a two-tier system is particularly suitable in this context and why in general certain board characteristics can be measured more exactly in a two-tier system than in a one-tier system. Finally, by simultaneously considering multiple variables of board effectiveness, rather than focusing on a single dimension, we create a broader view on their interaction and firm performance influence, taking into account how formal organizational structure can moderate the effect.

IDENTIFICATION OF BOARD CHARACTERISTICS

Investigating the impact of corporate governance on firm performance is usually undertaken by including various dimensions, focusing on specific board characteristics. These characteristics represent criteria or input parameters for the design of effective and robust corporate governance architectures. Board characteristics define distinctive attributes that are embodied by members of a board and provide a specifiable criterion to differentiate the board as a uniquely compound group of individuals. A commonly utilized example is for instance board diversity as a measure for how much boards differ internally in terms of members' background characteristics. Determining the effect of these board characteristics on firm performance mostly takes a contingency approach, as relations are highly depending on situational limitations. Reviewing the existing literature in this context reveals five board characteristics which have been thoroughly analyzed in prior research and shall be presented in the following.

Diversity

In order for firms to stay competitive, they have to rapidly and flexibly adapt to changes in their environment (Bettis, et al., 1995; Tuggle, et al., 2010). Thus, boards, as the most important internal monitoring and control device, play a crucial role (Daily, et al., 2003). Research from various disciplines on adaptability, creativity and decision-making suggests that board diversity could possibly facilitate this function in a changing environment. However, its detailed effect on key performance indicators is still subject to wide dispute among researchers (Golden, et al., 2001). Diversity in this context, is used to define the degree to which members of a group differ in terms of certain background characteristics (Pelled, et al., 1999; Bunderson, et al., 2002; Cannella, et al., 2008). When aiming for the optimal level of diversity within boards, one has to consider a natural tradeoff, which is very well explained by Kosnic 1990: if the level of diversity is too high among board members it tends to impede interaction and efficient communication. If, however, the level of diversity is too low, negative implications for corporate governance might occur due to groupthink and complacency (Kosnik, 1990). Moreover, diversity has to be regarded as a multidimensional concept, comprising various background characteristics at once. Geographical factors, gender, board demography and cognitive factors are among the most frequented parameter to be found in related studies (Finkelstein, et al., 1990; Pearce, et al., 1992; Boeker, 1997; Dalton, et al., 1999; Forbes, et al., 1999; Golden, et al., 2001). Given this level of complexity, current research streams have argued in favor of both, positive (Pearce, et al., 1992; Dalton, et al., 1999) and negative (Eisenhardt, et al., 1988; Golden, et al., 2001) correlations between diversity and firm performance, depending on the specifications of the research settings. Up to now “the black box between diversity and performance [therefore] is [still] complex” (Pelled, et al., 1999).

Board Activity

Traditionally, studying firm performance within the domain of corporate governance has centered on board activity issues. By this, we define the degree to which board members can dedicate themselves to their board functions. It is an accepted approach that informal relationships, created through more frequent board member interactions, facilitate information sharing and problem solving processes (Tuggle, et al., 2010). One could thus raise the question whether firm performance is positively influenced by a higher amount of board activity. To better understand this issue and to follow the request of enhancing the understanding about board processes and firm performance (Zahra, et al., 1989; Pettigrew, 1992), Tuggle conducted an in-depth research on the nature of board meetings (Tuggle, et al., 2010). They characterize board meetings as time-constrained and intensive work sessions, in which board members’ attention focus has to be directed in an efficient manner. Additionally, they distinguish between formal and informal board meetings, claiming that the degree of formality is crucial in influencing board members’ attention and that informalities will lead to a more efficient meeting culture. It is therefore suggested that greater board activity will positively impact firm performance, as members have more time to establish these informal relationships. Also, former studies support this perspective, emphasizing the positive influence on the level of trust among board members (Conway, 1995; Hansen, et al., 2004).

Board Compensation

It is widely acknowledged that board compensation is a crucial issue for firm performance (Ang, et al., 2002). Current research, however, places great emphasis on executive compensation schemes (Bushman, et al., 1996; Chung, et al., 1996), whereas non-executive compensation and especially implications in a two-tier system seem to be less investigated. Kosnik defines non-executive directors as board members who have neither been employed after, nor at the same time as they serve on its board (Kosnik, 1990). Corporate governance reformers and institutional shareholders suggest that giving those non-executive directors a financial stake in the firm performance will positively influence their monitoring function on management (Perry, 2000). This is supported by agency theory, which predicts that the agent's direction and amount of effort is dictated by performance measures (Waweru, et al., 2009). It can also be understood in the way that the agent's effort is focused on those dimensions being measured by the performance measurement system (Moers, et al., 2000). Therefore, the conclusion has been made that non-executive directors should be compensated with some kind of equity-based scheme to align their interests with those of the shareholders and thus improve their monitoring function (Perry, 2000). Among others, Perry finds empirical support, indicating that such incentive schemes can increase the sensitivity of CEO turnover to performance (Perry, 2000). Nevertheless, some contradictory studies also exist. According to agency theory, non-executive equity ownership is, expected to lead to a more diligent protection of stockholders' interests (Bacon, et al., 1975), Kosnik 1990 conducted studies on companies' greenmail decisions and found evidence figuring a correlation between non-executive equity interests and the resistance to greenmail (Kosnik, 1990). Furthermore, Waweru 2009 conducted studies showing no significant influence at all between non-executive salaries and the firm's value (Waweru, et al., 2009).

Strategic Decision Process

Separation of ownership and control in the decision-making process of big corporations inevitably creates conflicts of interests (Marris, 1964). This is especially important with respect to the time horizon of decisions - in particular in case the interests of executing and owning party diverge. Strategic decisions, which typically require long-term orientation, are a highly interesting field of research in this context. It has long been questioned how outside directors' contribution to the strategic decision-making process has an impact on firm performance. Agency theory and analysts suggest that executives' interests are more short-time oriented and risk-averse when it comes to long-term investments (Baysinger, et al., 1991). Non-executives, in turn, are expected to promote strategic long-term decisions that are in line with stockholders' interests (Kosnik, 1990). As a result, this traditional view would suggest that a high involvement of the supervisory board in strategic decision-making should benefit the company in the long run, and hence yield a positive effect on its financial performance. Contradicting this traditional view, some more recent studies imply that under certain limitations, the amount of executives may positively correlate with formulating effective strategic decisions. This counterintuitive finding is supported amongst others by Baysinger et al. 1991, who investigated how outside directors influence corporate R&D decisions (Baysinger, et al., 1991). Their findings support earlier studies by Hill and Snell (1988), who found the same correlation. These results suggest that, although the involvement of non-executive board members in the strategic decision process generally seems to play an important role for firm performance, factors such as compensation schemes and control mechanisms seem to be a crucial trigger in this context and can highly influence behavior to act against the theoretically predicted behavior patterns (Baysinger, et al., 1991; Hayes, et al., 2007).

Independence

Independence of board members constitutes a crucial element in the decision-making process of a firm. As for the one-tier system independence is defined as a structural character, measured by the proportion of outside directors (Golden, et al., 2001). Although there has been much research on this topic for decades, evidence of systematic performance effects is still missing (He, et al., 2011). Dalton et al. 1998 provide a comprehensive overview of the theoretical approach and the different schools dealing with the relationship of independence and firm performance. According to their research, two major schools have to be consulted, being Agency and Stewardship Theory. Each of these claims that different amounts of independence positively influence firm performance (Dalton, et al., 1998). Agency Theory suggests that a separation of ownership and control will generally lead to actions of self-interest by the controlling party. It therefore draws the conclusion that effective boards are those with a large number of outside directors as their temptation to follow these behavioral patterns is lower (Dalton, et al., 1998). Studies providing empirical support for this assumption are for instance Ezzamel and Watson (1993), Baysinger and Butler (1985) and Pearce et al. (1992). In contrast, Stewardship Theory expresses a general trust in the controlling party. It argues that control should be centralized in the hands of management, as they possess the deepest comprehension of the business. Researchers in favor of Stewardship Theory argue therefore that an increase in the proportion of inside directors will lead to better firm performance (Dalton, et al., 1998). Empirical support for this thesis can be found for example in the studies of Kesner (1987) and Vance (1964, 1978). Besides these two schools there exists empirical evidence showing no correlation between independence and firm performance at all. Daily and Dalton (1992), and Dalton et al., (1998) are important representatives of this perspective.

The existing literature is dominated by an emphasis on studying these five board characteristics and their performance effects in the corporate governance structure of the one-tier system. Monistic and dualistic board systems, however, show a wide range of differences, offering new interesting perspectives for research on board effectiveness. The most important distinction thereby lies in the clear separation of control and management in the dualistic system, which in a company's day to day business may have positive and negative implications alike. On the one hand it potentially increases protection of stakeholder interests, on the other it may lead to problems of information asymmetries between supervisory boards and management boards, structural weaknesses and more complicated decision making processes. In light of the present research question, however, the distinction between control and management in the two-tier system provides a clear advantage, as it facilitates the separation between executive and non-executive board members in the experimental setting. Whereas this distinction often imposes problems in a one-tier system testing, it is naturally given in the two-tier system. We therefore propose that analyzing board characteristics and their effects on firm performance in a two-tier system is an especially favorable approach and will, under certain conditions, enable a more refined picture and a reduction of potential measurement errors. Since there are no explicit empirical studies in this context so far, we want to shed light on this issue by testing the five above-explained board characteristics explicitly in dualistic corporate governance structures.

Doing so, we not only search to enrich the present understanding of performance and board work influence, but also try to open the way for a better setting of measurement in this field.

DATA AND METHODS

This study is part of a larger multidisciplinary project on supervisory boards in Germany and Austria. The setting for that study was represented by the Top 500 (by revenue) companies in Germany and Austria. We used a questionnaire-based research method designed to approach the incumbent chairmen of these boards in order to get the most accurate data available. We designed a survey to gather information on the nature and composition of supervisory boards, along the dimensions suggested different and complementary literature streams including strategic, leadership, governance and law. Performance measures were obtained by computing an average ROA over a three year period. ROA is widely used as a measure of performance, and has been used in other studies in the field of corporate governance. We have further divided the industry by performance (Grant, 2008) into groups to equalize the effect of different capital intensity of industries. Therefore, in the present study we aimed to leverage on a broader effort and formulate hypothesis to be tested on an existing proprietary database.

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